

**MCI Communications
Corporation**

MCI

1801 Pennsylvania Avenue, NW
Washington, DC 20006

ORIGINAL

OFFICE OF THE SECRETARY
FEDERAL COMMUNICATIONS COMMISSION

December 2, 1998 EX PARTE OR LATE FILED

DEC 2 - 1998

RECEIVED

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
Room 222
1919 M Street NW
Washington, D.C. 20554

EX PARTE

Re: CC Docket No. 96-128: Implementation of the Pay Telephone Reclassification
and Compensation Provisions of the Telecommunications Act of 1996

Dear Ms. Salas:

A number of payphone cost studies are now a part of the record in CC Docket No. 96-128, including the cost calculations made by the Commission in the Second Report and Order, CC Docket No. 96-128, FCC 97-371 (October 9, 1997). The purpose of this letter is to provide a brief overview of the differences between the Commission's per-call cost calculations in the Second Order and those studies on the record.

Payphone Cost Studies

The most important differences among the "bottom-up" cost estimates are driven by four factors: a) the number of calls; b) station investment; c) the treatment of locational rents; and d) the allocation of costs to coin calls. There are other differences that do make a few cents difference in the estimates; however, the four factors above individually have a considerable impact on the cost estimates.

Estimating the cost of a call is typically conducted by converting the capital costs of installing a payphone into a monthly payment, adding the monthly recurring charges such as line costs, maintenance, coin collection, and so forth, and then dividing by a quantity of calls. The smaller the quantity of calls, of course, the higher is the cost estimate. To estimate the cost of coinless calls, all costs directly attributable to the coin calls (e.g., line usage fees, coin mechanism) are removed from this monthly cost estimate and the remainder is divided by the total number of calls.

All the cost studies use an algorithm that allocates joint and common costs to the various types of calls. They are, for the most part, remarkably similar in algorithm and differ

No. of Copies rec'd 0 + 1
List A B C D E

primarily in the input values. The various differences among the cost "studies" are discussed below in the order of the algorithm.

Station Investment

Station investment includes the cost of the phone, pedestal, enclosure, installation, line initialization, and so forth. The estimated investment varies substantially among the parties. The typical payphone device itself costs about \$900 (the basic "smart" phone), although the semi-smart phone (tabletop) are considerably cheaper (\$250-300). Also, there is an active market for used payphone equipment.

In its Second Order, the FCC used station investments of \$2,799 to \$3,234. These numbers were *derived* from data provided in the 10-K financial statements of two payphone operators (Peoples and CCI). Potential problems with these figures are that they a) represent embedded costs; b) are affected by the accounting procedures of the companies; and c) required the FCC to make adjustments for "depreciated" plant.

The cost studies of both AT&T and MCI use station investment figures substantially below that of the FCC. The AT&T Cost Study uses a station investment of \$1,895 while the MCI Cost Study has a station investment of \$1,650 (for the typical payphone). Both studies, and in particular the MCI study, provide detailed backup information on these estimates. The station investment for semi-smart (desktop) phones is much less (MCI estimate is \$414). These estimates represent neither "embedded" costs nor "forward looking" costs - they are, quite simply, the cost of installing a "typical" or "average" payphone today.

Keep in mind that every \$100 in station investment amounts to about \$1.70 in monthly costs (this figure will vary slightly by the method used to amortize the investment) or about \$0.0024 per call at 700 calls (proposed quantities of calls vary between 540 and 720 calls). The FCC station investment figures are about \$1,200 higher than AT&T and MCI, increasing the per-call cost by about \$0.03.

It is important to recognize that the choice of equipment is endogenous, i.e., you build the plant to suit the output. If traffic is so low that you cannot justify installing a \$900 phone in a \$500 enclosure, you can buy a \$300 phone and place it on a table. Pedestal and enclosure costs (inside or outside?) can make a substantial difference in the investment costs. These investment options are especially important when considering the impact of a compensation rate on the profitability of lower volume locations. As discussed below, the ability to scale the "payphone plant" to the location emphasizes an error in the Commission's approach in the Second Order. Specifically, the Commission combined *average* payphone cost data with call quantities from a "marginal" or a low volume phone.

Monthly Recurring Expenses

Monthly recurring expenses are typically broken down into about seven categories: a) line costs including usage, SLCs, 911, and taxes; b) collection/maintenance; c) line coding (ANI); d) overhead/SG&A; e) bad debt; f) interest charges; and g) locational rents (commissions). Unlike station investments, small differences in monthly expenses can make large differences in the per-call compensation rate. Every \$7 in monthly recurring expenses adds \$0.01 (at 700 calls) to the per-call rate.

Line costs are roughly similar among the studies (about \$50-60 total, with \$15-30 usage). The amount of usage (payments to LEC per local call) is key because that amount is attributable to coin calls alone and will be subtracted from the monthly costs for the coinless cost estimate.

Maintenance costs are generally estimated at about \$20-25 per month, though some estimates were closer to \$40. Both AT&T and Sprint have large payphone operations and their estimates are about \$21. The FCC used roughly \$24 in its calculations. Collection costs are typically lumped together with maintenance, since maintenance is often conducted when collecting coins. Some parties allocate portions of maintenance and collection to the coin calls, since a good part of that work is related solely to the coin calls. The FCC did not make such an allocation.

Line coding costs vary substantially among the parties. The FCC assumes about \$5.42 per month, while MCI's Cost Study estimates the cost to be \$1.46 per month (an average of LEC tariffed rates for the coding service). Line coding is viewed as a cost attributable to coinless calls alone. Better estimates should be now available given that the service is tariffed by many LECs.

Overhead/SG&A estimates vary substantially among the parties. The FCC assumed about \$28 in overhead costs, while MCI assumes \$10.86. The MCI estimate is based on a 10.4% expense factor that was derived from ARMIS data while the FCC figure was based on estimates provided by CCI (a payphone operator). Whether or not some portion of overhead should be assigned solely to coin costs is the subject of debate. AT&T contends that about one-half should (since some of this will relate to coin collection, etc.). Also, the overhead/SG&A costs used by the FCC was for an "average" phone, while the call quantity was for the "marginal" phone. Using an expense factor allows the overhead to vary with the quantity of calls.

The FCC ignores expenses related to bad debt because of poor data. The FCC does add \$3.79 per month in interest expenses to account for the three-month delay between the date of the call and the date compensation is received. Other studies do not include this expense.

Locational rent, averaging about \$50 per month, is the subject of much debate, though all the cost studies treat these rents as profits and not as an expense. The FCC assumes it is

zero at the marginal phone, while AT&T and MCI treat it as profit and not a true economic cost. At 700 calls, including locational rent would raise the compensation rate by \$0.07.

Number of Calls

The number of calls is perhaps the most important factor in determining per-call compensation and is responsible for much of the rate variance across studies. In the Second Order, the cost calculations were made using call quantities (542 calls) from a hypothetical marginal phone ("we estimated costs of the installation and operation of a payphone at a low traffic location (Second Order, ¶ 99)"). Numerous "averages" were presented on the record (720, 713, 689, among others). Payphone operators have presented more recent data showing the average call counts have declined below the "700" mark. This reduction in calls would be expected given the recent 40% increase in the local coin rate across many locations. Since some parties argue that this increase was a consequence of market power, it is not clear that these new call counts are appropriate for the cost calculation. Also, note that setting the compensating rate using marginal phone call quantity implies that *all existing phones are overcompensated*. One party (E-Group) estimates that the reduction in consumer welfare resulting from this type of overcompensation will be substantial.

As mentioned above, the use of call quantities from a "marginal" phone with cost data from the average phone is not appropriate, and this mis-match error was made in the Second Order. For certain, the coin collection and maintenance cost would be lower at a low volume phone. Station investment also might be considerably lower. The lack of data on "marginal" phone costs, but various estimates for the average phone, suggests that using average call quantities is a more sensible approach.

The effect of the number of calls on the per-call compensation rate is illustrated in the table below. A number of different monthly costs values are provided for illustrative purposes.

		Calls			
		500	600	700	800
Monthly Cost	\$150	0.300	0.250	0.214	0.188
	\$80	0.160	0.133	0.114	0.100
	\$10	0.020	0.017	0.014	0.013

Allocation of Coin Costs

What costs are allocated to the coin calls can have a considerable impact on the compensation rate. In the Second Order, the Commission allocated only two things to coin calls: \$710 in station investment (from AT&T study) to the coin mechanism and removed usage charges from the line rate. All the other monthly expense categories, including coin collection and maintenance, were treated as joint and common. Other studies allocate at least some of the coin collection/maintenance costs (and in some cases overhead) to coin

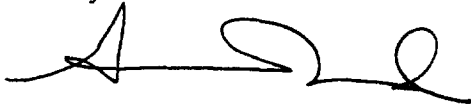
calls. Also, in the MCI Study, USF expenses were allocated to coin calls because USF charges are based on end-user revenues. Coinless calls produce no revenue and compensation is not subject to the USF charge.

Conclusion

Relative to the other cost studies on the record, the Second Order's "bottom-up" cost calculation differs primarily in the following respects: a) overstates station investment; b) does not allocate at least some portion of coin collection and maintenance cost to coin calls; c) uses too few calls; and d) overstates ANI/coding costs. Differences in the treatment of USF charges, overhead, and interest expenses vary among the studies and warrant careful consideration.

Please add this letter to the record of this proceeding.

Sincerely,

A handwritten signature in black ink, appearing to be 'G. S. Ford', with a stylized, looping flourish at the end.

George S. Ford

cc:	J. Casserly	T. Power
	P. DeGraba	M. Price
	K. Dixon	G. Reynolds
	J. Duvall	B. Rogerson
	P. Gallant	D. Stockdale
	G. Lipscomb	L. Strickling
	K. Martin	C. Stroup